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IN THE

Supreme Court of the United States

No. 547. OCTOBER TERM, 1931.

THE INSURANCE COMPANY OF THE STATE OF PENNSYLVANIA,

Appellant,

v.

JOSEPH S. MacLAUGHLIN, Collector of Internal Revenue For the First District of Pennsylvania,

Appellee.

ON CERTIFICATE FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR THE INSURANCE COMPANY OF THE STATE OF PENNSYLVANIA, APPELLANT.

EDWARD M. BIDDLE,
1600 Arch Street,
Philadelphia, Pa.,

ROBERT C. WALKER,
ROBERT T. McCRACKEN,
1421 Chestnut Street,
Philadelphia, Pa.,
Attorneys for Appellant.

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In the Supreme Court of the United States.

OCTOBER TERM, 1931. No. 547.

The Insurance Company of the State of Pennsylvania,

Appellant,

v.

Joseph S. MacLaughlin, Collector of Internal Revenue for the First District of Pennsylvania,

Appellee.

BRIEF FOR THE INSURANCE COMPANY OF THE STATE OF PENNSYLVANIA, APPELLANT.

I. THE OPINION OF THE COURT BELOW.

The opinion of the District Court for the Eastern District of Pennsylvania, by Judge Kirkpatrick, is reported in 49 Federal Reporter (2d Series) 361.

The United States Circuit Court of Appeals for the Third Circuit, without deciding the case, has certified to this Court the question involved.

The opinion of the District Court, not being included in the Certificate, is set forth in full at the end of this brief beginning at page 23 (Appendix A).

II. JURISDICTION.

The question here presented has been certified to the Supreme Court of the United States by the Circuit Court of Appeals for the Third Circuit under the authority of Section 239 of the Judicial Code, as amended by the Act of February 13, 1925 (U. S. Code, Title 28, Section 346).

III. STATEMENT OF THE CASE.

A full statement of the case has been set forth in the Certificate of the Circuit Court of Appeals for the Third Circuit and in the interest of brevity the statement is not repeated at this point.

IV. ARGUMENT.

Summary of the Argument.

If under the new clause (b) (1) (B) of Section 204 of the Revenue Act of 1928,[1] effective January 1, 1928, the basis to be used by an insurance company (other than a life or mutual insurance company) in computing "gain during the taxable year from the sale or other disposition of property," acquired before and disposed of after January 1, 1928, be the fair market value of such property as of March 1, 1913, or other basis provided by Section 113 of the Act, said new clause is unconstitutional because it taxes capital.

(1) The power of Congress under the Sixteenth Amendment is only to lay a tax on income.

(2) The meaning of the word "income" in Income Tax Acts is definitely settled by the decisions of this Court.

(3) Any increased value that accrued before January 1, 1928, the effective date of the new clause in question, is capital and not income.

(4) Comments on authorities relied on by Appellee.

(5) Conclusion.

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[1] The pertinent provisions of the Revenue Act of 1928 are set forth at page 37 of this brief as Appendix B.

(1) The power of Congress under the Sixteenth Amendment is only to lay a tax on income.

The validity of the Revenue Act of 1928, as the tax under it is not apportioned among the states, is derived from the Sixteenth Amendment. The title of the Sixteenth Amendment is "Income Tax," and the language used in the body of the Amendment states that the power given to Congress is "to lay and to collect taxes on incomes." Therefore to tax capital under the Revenue Act of 1928 is not within the power of Congress.

Under the Sixteenth Amendment for the first time Congress was empowered to tax income from property without apportioning the tax among the states according to population: **Southern Pacific Co. v. Lowe (1917), 247 U. S. 330, 335.** Any part of the Act which places a tax on capital renders such part unconstitutional and void.

The Sixteenth Amendment is as follows:

"INCOME TAX

"The congress shall have power to lay and collect taxes on incomes from whatever sources derived, without apportionment among the several states, and without regard to any census of enumeration."

(2) The meaning of the word "income" in Income Tax Acts is definitely settled by the decisions of this Court.

In the case of **Bowers, Collector of Internal Revenue v. Kerbaugh-Empire Co., 271 U. S. 170, 46 Sup. Ct. Rep. 449,** decided May 3, 1926, which presented a question arising under the Revenue Act of 1921, suit having been brought by the plaintiff to recover taxes assesesd against it and paid under protest, this Court said (p. 174):

> "'Income' has been taken to mean the same thing as used in the Corporation Excise Tax Act of 1909 (36 Stat. 112), in the Sixteenth Amendment, and in the various revenue acts subsequently passed. Southern Pacific Co. *v.* Lowe, 247 U. S. 330, 335; 38 S. Ct. 540, 62 L. Ed. 1142; Merchants' L. & T. Co. *v.* Smietanka, 255 U. S. 509, 519, 41 S. Ct. 386, 65 L. Ed. 751, 15 A. L. R. 1305. * * *
>
> "In determining what constitutes income substance rather than form is to be given controlling weight. Eisner *v.* Macomber, *supra,* 206 (40 S. Ct. 189)."

In the case of **Merchants' Loan & Trust Co. v. Smietanka, 255 U. S. 509, 41 Sup. Ct. Rep. 386,** decided March 28, 1921, involving the income tax Act of 1916, as amended by the Act of 1917, this Court said (p. 518):

"It is obvious that these decisions (under the Corporation Excise Tax Act of August 5, 1909) in principle rule the case at bar if the word 'income' has the same meaning in the Income Tax Act of 1913 that it had in the Corporation Excise Tax Act of 1909, and that it has the same scope of meaning was in effect decided in Southern Pacific Co. *v.* Lowe, 247 U. S. 330, 335, 38 Sup. Ct. 540, 62 L. Ed. 1142, where it was assumed for the purposes of decision that there was no difference in its meaning as used in the Act of 1909 and in the Income Tax Act of 1913 (38 Stat. 114). There can be no doubt that the word must be given the same meaning and content in the Income Tax Acts of 1916 and 1917 that it had in the Act of 1913. * * * there would seem to be no room to doubt that the word must be given the same meaning in all of the Income Tax Acts of Congress that was given to it in the Corporation Excise Tax Act, and that what that meaning is has now become definitely settled by decisions of this Court."

(3) Any increased value that accrued before January 1, 1928, the effective date of the new clause in question, is capital and not income.

Doyle, Collector of Internal Revenue, v. Mitchell Brothers Co., 247 U. S. 179, decided May 20,

1918, was an action to recover from the Collector additional taxes assessed against the plaintiff under the Corporation Excise Tax Act of August 5, 1909, and paid under protest, that Act having imposed on every corporation organized for profit an excise tax equivalent to one per cent. on the entire net income above $5,000 received from all sources during the year.

The plaintiff in that case was a lumber manufacturing corporation which operated its own mills, manufactured into lumber therein its own stumpage, sold the lumber in the market, and from these sales and sales of various by-products made its profits, declared its dividends and created its surplus. Plaintiff acquired certain timber lands at its organization in 1903 and paid for them at a valuation approximately equivalent to $20 per acre. Owing to increases in the market price of stumpage the market value of the timber land on December 31, 1908, had become approximately $40 per acre. The company made no entry upon its books representing this increase, but each year entered as a profit the difference between the original cost of the timber cut and the sums received for the manufactured product, less the cost of manufacture. After the passage of the Excise Tax Act, and preparatory to making a return of income for the year 1909, the company revalued its timber stumpage as of Decem-

ber 31, 1908, at approximately $40 per acre. The good faith and accuracy of this valuation were not in question, but the figures representing it never had been entered in the corporate books.

Under the act the company made a return for each of the years 1909, 1910, 1911, and 1912, and in each instance deducted from its gross receipts the market value, as of December 31, 1908, of the stumpage cut and converted during the year covered by the tax. There appears to have been no change in its market value during these years.

The Commissioner of Internal Revenue having allowed a deduction of the cost of the timber in 1903 and having refused to allow the difference between that cost and the fair market value of the timber on December 31, 1908, the question was whether this difference (made the basis of the additional taxes) was income for the years in which it was converted into money, within the meaning of the act.

After referring to the provisions of the Corporation Excise Tax Act of August 5, 1909, which became effective January 1, 1909, this Court said (p. 183):

> "An examination of these and other provisions of the act makes it plain that the legislative purpose was not to tax property as such, or the mere conversion of property, but to tax the conduct of the business of corpora-

tions organized for profit by a measure based upon the gainful returns from their business operations and property from the time the act took effect. * * *

"The formula that the entire receipts derived from a conversion of capital assets after deducting cost value must be treated as net income, so far as it is applied to a conversion of assets acquired before the act took effect and so as to tax as income any increased value that accrued before that date, finds no support in either the letter or the spirit of the act, and brings the former into incongruity with the latter. * * *

"In order to determine whether there has been gain or loss, and the amount of the gain if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.

"This has been recognized from the beginning by the administrative officers of the government. Shortly after the passage of the act, and before the time (March 1, 1910) for making the first returns of income, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, promulgated Regulations No. 31, under date December 3, 1909, for the guidance of collectors and other subordinate officers in the performance of their duties under the act. * * * The matter of income arising from

a profitable sale of capital assets was dealt with specifically in such a way as to limit the tax to income arising after the effective date of the act. This was done by adopting the rule that an advance in value arising during a period of years should be so adjusted that only so much as properly was attributable to the time subsequent to January 1, 1909 (December 31, 1908, would have been more precise), should be subjected to the tax. Subsequent treasury regulations promulgated from time to time (T. D. 1606), March 29, 1910, paragraphs 40, 71, 76; T. D. 1675, February 14, 1911, paragraphs 37, 55, 75; T. D. 1742, December 15, 1911, paragraphs 43, 62, 86, 91), adhered to the same rule with respect to lands bought prior to January 1, 1909, and sold during a subsequent year, prescribing, however, that the profits, when not otherwise accurately determinable, should be prorated according to the time elapsed before and after the act took effect; and gave to it an application especially pertinent here, one of the regulations reading:

" 'The mere removal of timber by cutting from timber lands, unless the timber is otherwise disposed of through sales or plant operations, is considered simply a change in form of assets. If said timber is disposed of through sales or otherwise, it is to be accounted for in accordance with regulations

governing disposition of capital and other assets.'

"In our opinion these regulations correctly interpret the act in its application to the facts of the present case. When the act took effect, plaintiff's timber lands, with whatever value they then possessed, were a part of its capital assets, and a subsequent change of form by conversion into money did not change the essence. Their increased value since purchase, as that value stood on December 31, 1908, was not in any proper sense the result of the operation and management of the business or property of the corporation while the act was in force. * * *

* * * the deduction did but restore to the capital in money that which had been withdrawn in stumpage cut, leaving the aggregate of capital neither increased nor decreased, and leaving the residue of the gross receipts to represent the gain realized by the conversion, so far as that gain arose while the act was in effect. This was in accordance with the true intent and meaning of the act."

That the case of Doyle *v.* Mitchell Brothers Co. *supra* is still recognized as a leading authority upon this subject by this Court is shown by a recent reference thereto by Mr. Justice Stone in the case of Burnet, Commissioner of Internal

Revenue v. Sanford and Brooks Company, 282 U. S. 359 (1930), where he says on page 364:

> "They (the expenditures in question) were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income. See Doyle *v.* Mitchell Bros. Co. *supra,* p. 185."

In the case of **Hays, Collector of Internal Revenue, v. Gauley Mountain Coal Co., 247 U. S. 189, 38 Sup. Ct. Rep. 470,** decided May 20, 1918, the coal company had purchased in 1902 certain shares of another mining corporation for $800,000, and sold them October 16, 1911, for $1,010,000, greater by $210,000 than cost. That case likewise was a suit to recover taxes alleged to have been unlawfully collected under the Corporation Excise Tax Act of August 5, 1909, in which this Court said (p. 192):

> "This brings us to consider whether the proceeds of the sale of stock by respondent in October, 1911, included anything, and if so how much, of 'income' accruing on or after January 1, 1909, as the term 'income' is employed in the act. * * *
>
> "It results that so much of the $210,000 of profits as may be deemed to have accrued subsequent to December 31, 1908, must be treated as a part of the 'gross income' of

the respondent. For it is the simple case of a conversion of capital assets acquired before and turned into money after the taking effect of the act; and, as we have shown in Doyle, Collector, *v.* Mitchell Brothers Co., *ante* 179, since the conversion of capital often results in gain, the general purpose of the act of 1909 to measure the tax by the increase arising from corporate activities together with the income from vested property leads to the inference that that portion of the gross proceeds which represents gain or increase acquired after the taking effect of the act must be regarded as 'gross income'; and to this end it must be distinguished from that portion which represents a return of the capital value existing before. In order to do this, it is necessary to ascertain what was the value of the capital assets on December 31, 1908."

In the case of **United States v. Cleveland, C. C. & St. L. Ry. Co., 247 U. S. 195, 38 Sup. Ct. Rep. 472,** decided May 20, 1918, which also arose under the Act of 1909, this Court said (p. 195):

"In January, 1900, the respondent purchased 30,000 shares of stock of the Chesapeake & Ohio Railway Company for $981,427.92, and sold them January 28, 1909, for $1,795,719—a profit of over $814,000. It included no portion of this profit in its return for the year 1909 under the

Corporation Excise Tax Act of August 5, 1909 (chapter 6, 36 Stat. 11, 112, Sec. 38), and the United States brought this suit to recover the tax of 1 per cent. thereon. * * *

"For reasons sufficiently stated in Doyle *v.* Mitchell Brothers Co., and Hays *v.* Gauley Mountain Coal Co., *ante* pp. 179-189, we concur in the view that defendant was not taxable except with respect to so much of the profit upon the stock as accrued after December 31, 1908."

Lynch, Collector of Internal Revenue, v. Turrish, 247 U. S. 221, 38 Sup. Ct. Rep. 537, decided June 3, 1918, was a suit to recover an income tax, paid under protest, assessed under the Act of October 3, 1913, c. 16, 38 Stat. 166.

Plaintiff's stock, acquired in 1903 for $79,975, doubled in value and he received for it $159,950 on December 31, 1913, the value on that date, however, being no greater than on March 1, 1913. The purchaser, which had an option on the stock, shortly before December 31, 1913, informed the company in which plaintiff held his stock that instead of exercising the option it preferred and proposed to purchase all of the assets of that company, paying to it such a purchase price that there would be available for distribution to its stockholders twice the par value of their stock. In this way, upon the surrender of his shares,

the plaintiff received the sum of $159,950, this being double their par value.

The plaintiff made a return of his income for the calendar year 1914, which showed he had no income for that year.

In upholding plaintiff's position that he was not subject to income tax for the year 1914, this Court said (p. 227):

> "The argument (of the government), in effect, makes any increase of value of property income, emerging as such and taxable at the moment of realization by sale or some act of separation, as by dividend declared or by distribution, as in the instant case. * * *
>
> "The latter case (Bailey *v.* Railroad Company, 22 Wall. 604, 635, 636, 22 L. Ed. 840) came here again in 106 U. S. 109, and it was then declared that the purpose of an income tax law was to tax the income for the year that it accrued; in other words, no tax in contemplation of the law accrues upon something except for the year in which that something—earnings, profits, gains or income—accrues. In that case the subject of the tax was a scrip dividend, but the certificates did not show the year of the earnings and testimony as to the particular year was admitted. The principle applies to the case at bar. If increase in value of the lands was income, it had its particular time and such time must have been within the time of the

law to be subject to the law, that is, it must have been after March 1, 1913."

In the case of **Southern Pacific Co. v. Lowe, Collector of Internal Revenue, 247 U. S. 330, 38 Sup. Ct. Rep. 540,** decided June 3, 1918, which presented a question arising under the Federal Income Tax Act of October 3, 1913, suit having been brought by plaintiff to recover taxes assessed against it and paid under protest, this Court said (p. 335):

> "Certainly the term 'income' has no broader meaning in the 1913 act than in that of 1909 (see Stratton's Independence *v.* Howbert, 231 U. S. 399, 416, 417, 34 Sup. Ct. 136, 58 L. Ed. 285), and for the present purpose we assume there is no difference in its meaning as used in the two acts. This being so, we are bound to consider accumulations that accrued to a corporation prior to January (March) 1, 1913, as being capital, not income, for the purposes of the act. And we perceive no adequate ground for a distinction, in this regard, between an accumulation of surplus earnings, and the increment due to an appreciation in value of the assets of the taxpayer. * * *
>
> "We base our conclusion in the present case upon the view that it was the purpose and intent of Congress, while taxing 'the entire net income arising or accruing from all

> sources' during each year commencing with the 1st day of March, 1913, to refrain from taxing that which, in mere form only, bore the appearance of income accruing after that date, while in truth and in substance it accrued before; * * *."

Applying the authorities to the facts presented in the case at bar, we are led to the inevitable conclusion that the value of the capital assets of insurance companies (other than life or mutual) on December 31, 1927, represented their capital and that upon the conversion of the same into cash at a subsequent date they were entitled "to have this capital restored," to apply the language of Mr. Justice Stone in Burnet *v.* Sanford and Brooks Company, *supra,* "before there is a capital gain taxable as income," under the new provision of Section 204 of the Revenue Act of 1928.

Counsel for the government in their brief filed in the Circuit Court of Appeals attempted to minimize the effect of the foregoing cases by arguing that the language quoted from Southern Pacific *v.* Lowe, *supra,* Doyle *v.* Mitchell Brothers Co., *supra,* and Hays *v.* Gauley Mountain Coal Company, *supra,* is mere dictum and was not necessary for the decision of the questions there presented. It is submitted that these cases speak for themselves, that the language used is unequiv-

ocal, and that when Justice Pitney says, in Southern Pacific *v.* Lowe, that "We are bound to consider accumulations that accrued to a corporation prior to January (March) 1, 1913, as being capital not income," it represents the pronouncement of this Court on this subject, and until reversed must be regarded as the law of the land.

The District Court, while agreeing with counsel for Appellant that "these decisions rule the instant case," held the pertinent provision of Section 204 of the Revenue Act of 1928 constitutional because the Court refused to adopt the construction contended for by the government and held that under the provisions of Section 204 the basis to be used in computing gain from the sale or other disposition of property owned on January 1, 1928 by insurance companies (other than life or mutual insurance companies) is the fair market value as of January 1, 1928, the effective date of the Act, and not the fair market value as of March 1, 1913, or other basis as provided by Section 113 of the Act. (See Page 3 of Certificate.)

(4) Comments on Authorities relied on by Appellee.

To rebut Appellant's argument that appreciation in capital assets of insurance companies

(other than life or mutual) prior to January 1, 1928, the effective date of the new clause here under consideration constitutes capital and cannot therefore be constitutionally taxed as income, counsel for the government relied in the Circuit Court of Appeals upon several authorities. These authorities will be fully dealt with under the heading of "Comments on Authorities relied on by Appellant" (the government), in the brief filed on behalf of Alliance Insurance Company of Philadelphia, Appellee, in the companion case of Joseph S. MacLaughlin, Collector of Internal Revenue for the First District of Pennsylvania *v.* Alliance Insurance Company of Philadelphia, which was argued below contemporaneously with this case and which is now before this Court likewise on Certificate from the United States Circuit Court of Appeals for the Third Circuit as of October Term, 1931, No. 548. In the interest of brevity comments on such authorities are not repeated at this point.

(5) Conclusion.

It is Appellant's contention that the conclusion inevitably reached is that the gradual advance in the value of property of insurance companies (other than life or mutual insurance companies) before January 1, 1928, the effective

date of the new clause in question (Section 204 (b) (1), Clause (B) of the Revenue Act of 1928) constituted capital and therefore that said clause is unconstitutional and void, if construed as contended for by the government, because it places a tax on capital under the guise of a tax on income. Unquestionably, on December 31, 1927, before the effective date of said new clause, the increased value that had accrued on Appellant's capital assets constituted an increase of capital. Such being the situation on December 31, 1927, obviously it did not lie within the power of Congress to subsequently change the character of Appellant's assets and convert into income that which had acquired the fixed character of capital.

It follows that the amount of tax assessed and collected by Appellee from Appellant under Section 204 (b) (1) Clause (B) of the Revenue Act of 1928, which Appellant seeks to recover, was illegally assessed and collected, and that the question certified by the Circuit Court of Appeals for the Third Circuit should be answered in the affirmative.

Respectfully submitted,

EDWARD M. BIDDLE,
ROBERT C. WALKER,
ROBERT T. MCCRACKEN,
Attorneys for Appellant.

APPENDIX A.

IN THE DISTRICT COURT OF THE UNITED STATES, FOR THE EASTERN DISTRICT OF PENNSYLVANIA.

ALLIANCE INSURANCE COMPANY OF PHILADELPHIA *v.* JOSEPH S. MACLAUGHLIN, Collector of Internal Revenue for the First District of Pennsylvania.	No. 15700. September Term, 1930.

THE INSURANCE COMPANY OF THE STATE OF PENNSYLVANIA *v.* JOSEPH S. MACLAUGHLIN, Collector of Internal Revenue for the First District of Pennsylvania.	No. 15702. September Term, 1930.

OPINION.

Sur Statutory Demurrer.

(Filed March 10, 1931.)

KIRKPATRICK, *J.*

In these two actions at law the plaintiffs are suing to recover income taxes paid by them for

the calendar year 1928. The cases are before the court upon statutory demurrers which, under the Pennsylvania Practice Act, admit all the facts pleaded, and the single issue in both cases is whether the assessment and collection of the taxes was legal.

The plaintiffs are stock fire insurance companies incorporated under the laws of Pennsylvania and conducting the usual business of fire insurance companies. The taxes were assessed under the Revenue Act of 1928 and were based upon gain accruing to the plaintiffs from the sale during the year 1928 of securities owned by them, and acquired prior to January 1, 1928.

The question involved is whether, in computing the amount of such gain, the basis to be used should be the fair market value of the property on March 1, 1913 or the cost if acquired after that date, and not the fair market value as of January 1, 1928, the effective date of the Revenue Act of 1928.

To see how the question arises it will first be necessary to review briefly the legislation bearing upon the question. The Revenue Act of 1913 and the subsequent Acts of 1916, 1917 and 1918 taxed all insurance companies in the same manner as corporations generally, and under these acts, gains derived from the sale or other disposition of property were taxable as income. The

Revenue Act of 1921, however, established an entirely new scheme for the taxation of insurance companies and, in Secs. 246 and 247, dealt specifically with insurance companies other than life and mutual. By the provisions of these sections such companies (which of course included stock fire insurance companies) were no longer subject to taxation upon gains from sales or other disposition of property, nor were they permitted to deduct losses sustained in like manner. The Revenue Acts of 1924 and 1926 reenacted substantially the provisions of Secs. 246 and 247 of the Act of 1921. Thus from January 1, 1921 until January 1, 1928, stock fire insurance companies were not subject to a tax upon gains derived from the sale of their property.

The attention of Congress was directed to this somewhat mysterious omission and the inequality which it produced between stock fire, casualty, and marine insurance companies on the one hand and mutuals on the other. As a result, in the Revenue Act of 1928 a clause taxing gains derived from the sale of property was added to the existing provisions for taxing insurance companies other than life or mutual, and the following provision of the Revenue Act of 1928 was enacted as part of Sec. 204:

> "(a) *Imposition of tax.* In lieu of the tax imposed by Sec. 13 of this title, there shall be

levied, collected, and paid for each taxable year upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows:

(1) In the case of such a domestic insurance company, 12 per centum of its net income, * * *"

"(b) *Definition of income, etc.* In the case of an insurance company subject to the tax imposed by this section—

(1) *Gross Income.* 'Gross income' means the sum of (A) the combined gross amount earned during the taxable year, from investment income and from underwriting income as provided in this subsection, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners, and (B) gain during the taxable year from the sale or other disposition of property; * * *"

The Revenue Act of 1928 deals with insurance companies, including those here involved, in Supplement G. The general provisions of the Act appear in Subtitle A, Subtitle B, and in Supplements A, B, C, and D of Subtitle C. Sec. 4 of Subtitle A is as follows:

"The application of the General Provisions and of Supplements A to D, inclusive, to each of the following special classes of

taxpayers, shall be subject to the exceptions and additional provisions found in the Supplement applicable to such class * * *"

Sec. 113 (a) and (b) of the Act appearing in Supplement B is as follows:

"(a) Property acquired after February 28, 1913. The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property * * *" (with certain exceptions which are not here pertinent).

"(b) Property acquired before March 1, 1913. The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be:

(1) The cost of such property (or, in the case of such property as is described in subsection (a)—(1), (4), (5), or (12) of this section, the basis as therein provided), or

(2) The fair market value of such property as of March 1, 1913, whichever is greater * * *"

The government's contention is simply that since there are no exceptions or additional provisions in Sec. 204 or, for that matter, anywhere in Supplement G, affecting the basis for determining gain or loss of stock fire, casualty or

marine insurance companies, Sec. 113 was intended to apply and to furnish the basis. It is further argued that only by so holding can stock insurance companies of the classes referred to be placed upon a parity with mutuals, since the latter in case of property sold during 1928 must compute the gain on the basis of its 1913 value.

But the statute (Title 1 of the Act) is an income tax law. The predominant intention running through all provisions is to tax income only. The Sixteenth Amendment is a grant of power to lay taxes upon incomes and the presumption is that Congress intended to act within its constitutional limits. Whatever may be read into the Act by implication must yield to a construction which will uphold the Act, unless a contrary intention is so clearly indicated as to make any other interpretation impossible with reason. This is the basis of the plaintiffs' position for they say that the construction contended for by the government would result in imposing a tax upon something not income at all but an accrual to capital matured before the passage of the Act.

A review of decisions under the Corporation Excise Tax Act of 1909 sustains the plaintiffs' view. These decisions in principle apply to the instant case, because the word "income" has the same meaning in the Income Tax Act that it had in the Corporation Excise Tax Act of 1909.

Merchant's Loan & Trust Company *v.* Smietanka, 255 U. S. 509.

In Doyle *v.* Mitchell Bros. Company, 247 U. S. 179, it was decided that an increase in value of corporate assets, the whole amount of which had accrued prior to January 1, 1909, the effective date of the Act, was not taxable although converted into money during the year 1909 at a price in excess of its value when acquired (which happened to be in 1903). The court said:

> "An examination of these and other provisions of the act makes it plain that the legislative purpose was not to tax property as such, or the mere conversion of property, but to tax the conduct of the business of corporations organized for profit by a measure based upon the gainful returns from their business operations and property from the time the act took effect * * *
>
> "The formula that the entire receipts derived from a conversion of capital assets after deducting cost value must be treated as net income, so far as it is applied to a conversion of assets acquired before the act took effect and so as to tax as income any increased value that accrued before that date, finds no support in either the letter or the spirit of the act, and brings the former into incongruity with the latter * * *
>
> "* * * In order to determine whether there has been gain or loss, and the amount

of the gain, if any, must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.

"This has been recognized from the beginning by the administrative officers of the Government."

In Hays *v.* Gauley Mountain Coal Company, 247 U. S. 189, the question was as to the basis for determining income under the Act of 1909 in case of securities of another company purchased in 1902 and sold in 1911 at a large profit. It was held that so much, and only so much of the increase in value of the shares as could be deemed to have accrued after December 31, 1908, was part of the company's gross income within the meaning of the Act. In the opinion, the court said:

"* * * the general purpose of the Act of 1909 to measure the tax by the increase arising from corporate activities together with the income from invested property leads to the inference that that portion of the gross proceeds which represents gain or increase acquired after the taking effect of the act must be regarded as 'gross income'; and to this end it must be distinguished from that portion which represents a return of the capital value existing before. In order to do this,

it is necessary to ascertain what was the value of the capital assets on December 31, 1908."

These decisions rule the instant case unless they have been subsequently over-ruled or modified. The government contends that the case of Merchant's Loan & Trust Company *v.* Smietanka, 255 U. S. 509, taken in connection with the case of Smietanka *v.* First Trust & Savings Bank, 257 U. S. 602, has just such effect, because (the government says) these two decisions deal with a situation exactly parallel to that involved in the instant cases, though the subject matter was a different tax—income tax payable by trustees.

The second case (Smietanka *v.* First Trust & Savings Bank, *supra*), which was decided under the Income Tax Act of 1913 and therefore should be read first, holds merely that the Income Tax of 1913 made no provision for taxing income held and accumulated by a trustee for unborn or unascertained beneficiaries. The first case (Merchant's Loan & Trust Company *v.* Smietanka, *supra*) arose under the later acts of 1916 and 1917. The question involved was the legality of a tax upon gain realized by a trustee who, on February 2, 1917, sold assets acquired prior to March 1, 1913. The trust arose under the will of a decedent who died in 1912 leaving a widow and four children, the provision of the will being that the income

was to be paid to the widow during her life and after her death to be used for the benefit of the children or their representatives until each should arrive at the age of twenty-five when each should receive his or her share of the trust fund. The widow and the four children were all living in 1917. Thus it will be seen that all the beneficiaries were and at all times had been in esse and ascertained. The Supreme Court sustained an assessment based upon the difference between the amount realized in 1917 and the March 1, 1913 value.

Although the court in the opinion referred to the fact that the Act of 1916 specifically levied a tax upon income accumulated in trust for the benefit of unborn or unascertained persons, this provision was mentioned only as showing the intention of Congress to treat the trustee as a "taxable person." That was the real point in the case, because the tax in its entirety had been assessed against and paid by the trustee and not by the beneficiaries, either life tenant or remainder men. As applicable to a trust in which the beneficiaries were in esse and ascertained, the two decisions establish no more than this: Prior to the Act of 1916 and 1917 no tax upon gains realized from sale of property and remaining undistributed in the hands of the trustee could have been assessed against the trustee. After the

Acts referred to the trustee was a taxable person and liable for the tax.

The decision in Merchant's Loan & Trust Company *v.* Smietanka does not touch the question whether, if the tax had been assessed against the beneficiaries, it could have been sustained without resort to the Acts of 1916 and 1917 or, to put it in another way, whether, if the sale had occurred prior to 1916, the beneficiaries could have been taxed under the Act of 1913. This seems to me to be the crux of the whole question here because, if gain realized in the sale of securities by a trustee had at all times since the Act of 1913 been taxable against the beneficiaries, then the effect of the Acts of 1916 and 1917 was simply to transfer the incidence of the tax to the trustee. This was really not levying a new tax and therefore it would follow that the decision would have no bearing upon the instant case for there is no dispute that the Revenue Act of 1928 levied an entirely new tax.

Now it seems clear enough to me that the tax involved in Merchant's Loan & Trust Company *v.* Smietanka could, prior to the Acts of 1916 and 1917, have been assessed, partly at least, against the beneficiaries. The Act of 1913 provided specifically that "* * * Trustees * * * shall make and render a return of the net income of the person for whom they act * * *" and that

trustees should deduct the normal tax on the income and pay it to the United States, the surtax to be paid by the beneficiaries. The reason the trust estate in the case of Smietanka *v.* First Trust & Savings Bank, escaped taxation was that there was no person in existence for whom the trustee acted. In the other case (Merchant's Loan & Trust Company *v.* Smietanka) the persons for whom the trustee acted were in existence and were undoubtedly taxable. The fact that the income was not distributed need not have caused any difficulty since it would have been simple enough to apportion the gain among the beneficiaries so that they could be assessed with the surtax.

It is evident that the Supreme Court never intended nor understood the decision in Merchant's Loan & Trust Company *v.* Smietanka, to rule that an increase in value accruing prior to the effective date of the act imposing the tax should be included in the taxable gain. Thus in Goodrich *v.* Edwards, 255 U. S. 527, a tax was assessed upon gain measured by an increase over the market value as of March 1, 1913 (the effective date of the Act under which the tax was assessed) though the property had been purchased several years earlier at a much lower figure. The court said: "It is plain that this assessment was on the profit accruing after

March 1, 1913, the effective date of the Act. * * * The question involved is ruled by No. 608, *supra,* (Merchant's Loan & Trust Company *v.* Smietanka) and the amount was properly taxed."

Of course, if it appeared clearly and unequivocally from the terms of the Act of 1928 that Congress intended to apply the measure for gains, provided for by Sec. 113, to insurance companies of the plaintiff's class the question of constitutionality would have to be met. But there are many things in the language and structure of the Act of 1928 which strongly suggest that Congress did not so intend and I cannot agree that the conclusion that Sec. 113 was intended to apply to the tax imposed by Sec. 204 (b) (1) (B) is necessary, or even permissible. The tax imposed by Sec. 204 is expressly stated to be "in lieu of the tax imposed by Sec. 13 of this title." Sec. 13 imposed a 12% tax on the net income of corporations generally which is the amount imposed by Sec. 204 and the effect of the phrase quoted above is to emphasize the intention to make Sec. 204, a scheme or code of taxation, complete in itself, applicable to insurance companies other than life or mutual without reference to the general provisions of the Act. No other reason can be suggested for providing that a tax of 12% should be "in lieu of" a tax

at the same rate already fixed for corporations generally.

This intention appears more clearly when Sec. 204 is examined in all its parts. Whenever it was intended to incorporate into Sec. 204 any of the general provisions of the Act such provisions were specifically referred to and included by express language.

For the reasons stated, I hold that the basis for determining gain upon which the assessment was made in the case of Alliance Insurance Company of Philadelphia *v.* Joseph S. MacLaughlin, Collector of Internal Revenue for the First District of Pennsylvania is not authorized by law. The affidavit of defense is therefore held to be insufficient and judgment may be entered for the plaintiff in that case in the amount claimed, with interest.

It is my opinion that the said clauses of the Revenue Act of 1928 when construed in keeping with the foregoing opinion are constitutional. For this reason I hold that the affidavit of defense in the case of The Insurance Company of the State of Pennsylvania *v.* Joseph S. MacLaughlin, Collector of Internal Revenue for the First District of Pennsylvania is sufficient, and judgment may be entered therein for the defendant.

By the Court:

W. H. KIRKPATRICK, *J.*

APPENDIX B.

The pertinent provisions of the Revenue Act of 1928 provide as follows:

Supplement B—Computation of Net Income.

(Supplementary to Subtitle B, Part II)

SEC. 111. (26 U. S. C. A. Sec. 2111). DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of gain or loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the basis provided in section 113, and the loss shall be the excess of such basis over the amount realized.

* * * * * * *

(d) *Recognition of gain or loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

SEC. 112. (26 U. S. C. A. Sec. 2112). RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, * * *.

SEC. 113. (26 U. S. C. A. Sec. 2113). BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Property acquired after February 28, 1913.*—The basis for determining the gain or loss from the sale or other disposition of property acquired after February 28, 1913, shall be the cost of such property. * * * (With exceptions not here material.)

(b) *Property acquired before March 1, 1913.*—The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be:

(1) the cost of such property * * * or

(2) the fair market value of such property as of March 1, 1913, whichever is greater. In determining the fair market value of stock in a corporation as of March 1, 1913, due regard shall be given to the fair market value of the assets of the corporation as of that date.

Supplement G—Insurance Companies.

SEC. 204. (26 U. S. C. A. Sec. 2204). INSURANCE COMPANIES OTHER THAN LIFE OR MUTUAL.

(a) *Imposition of tax.*—In lieu of the tax imposed by section 13 of this title, there shall be levied, collected, and paid for each taxable year upon the net income of every insurance

company (other than a life or mutual insurance company) a tax as follows:

(1) In the case of such a domestic insurance company, 12 per centum of its net income;

* * * * * * *

(b) *Definition of income, etc.*—In the case of an insurance company subject to the tax imposed by this section——

(1) GROSS INCOME.—"Gross income" means the sum of (A) * * *, and (B) gain during the taxable year from the sale or other disposition of property;

(2) NET INCOME.—"Net income" means the gross income as defined in paragraph (1) of this subsection less the deductions allowed by subsection (c) of this section.

* * * * * * *

(c) *Deductions allowed.*—In computing the net income of an insurance company subject to the tax imposed by this section there shall be allowed as deductions:

* * * * * * *

(5) Losses sustained during the taxable year from the sale or other disposition of property;

* * * * * * *